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BEFORE THE ARIZONA CORPORATION COMMISSION

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STAFF'S REPLY BRIEF

IN THE MATTER OF THE APPLICATION OF
EPCOR WATER ARIZONA, INC., AN ARIZONA
CORPORATION, FOR A DETERMINATION OF
THE CURRENT FAIR VALUE OF ITS UTILITY
PLANT AND PROPERTY AND FOR INCREASES
IN ITS RATES AND CHARGES FOR UTILITY
SERVICE BY ITS MOHAVE WATER DISTRICT,
PARADISE VALLEY WATER DISTRICT, SUN
CITY WATER DISTRICT, TUBAC WATER
DISTRICT, AND MOHAVE WASTEWATER
DISTRICT.

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") has already responded in its initial Post-Hearing Brief¹ to many of the arguments made by EPCOR Water Arizona, Inc. ("EWAZ" or "Company") and responds as follows to the closing briefs filed by the Company, the Residential Utility Consumer Office ("RUCO") and the Santa Cruz Valley Citizens Council ("SCVCC"). The purpose of this Reply Brief is not to repeat every point made in Staff's Initial Closing Brief, nor will it attempt to refute every single issue raised by the Company or RUCO; instead Staff relies upon its testimony on those issues not specifically addressed in this Reply Brief. The recommendations of Staff and its positions have been outlined in its Opening Brief as well as its testimony. Staff will highlight some of the major points of disagreement with the Company and RUCO in this brief.

I. RATE BASE ISSUES.**A. The Company's Debit Balances Should Be Adjusted As Recommended By Staff.**

The Company continues to maintain that the debit balances in some of its plant accounts are the result of early retirements.² The Company provided little if any evidence on why there appear to

¹ Staff notes two corrections in its Opening Brief. On page 3, line 7, it should read "40.24 percent equity." On page 13, line 20, "Arizoan" should be "Arizona". On page 16, line 15, delete the word "Staffs".

² Company Br. at 7.

1 be so many early retirements. As Staff testified, recurring instances of early plant retirements could be
2 an indication that the depreciation rates being used are inappropriate or do not accurately reflect the
3 estimated economic life of the underlying assets.³

4 The Company's description of how debit balances, through early retirements, occur is not in
5 dispute. It is the magnitude of those retirements and the lack of explanation by the Company that is in
6 question. The evidence in this matter showed that there were debit balances that were created through
7 incorrect accounting of asset adjustments or transfers that were accounted for as retirements.⁴ For
8 example, during the hearing, the Company admitted that there were three accounts that were in error
9 for Paradise Valley.⁵ Further, the Company posted early retirements in Mohave Water. The resulting
10 debit accumulated balances were a result of flood damage. While such an event was an insurable
11 event, the Company's predecessor chose to self-insure with a high deductible.⁶ The Company
12 admitted that insurance recovery would affect the balance.⁷ Events such as these cause Staff to
13 question the support for the early retirements made by the Company.

14 The Company also argues in support of its position that the Commission is somehow
15 constrained to make any changes with these debit balances, because these balances were approved in
16 prior decisions and there must be some finality of those decisions.⁸ Staff is not challenging a prior
17 Commission order. Staff is suggesting that the Company support its plant balances in the *current*
18 application, as is the obligation of every applicant.

19 In an attempt to bolster its position, the Company cites the *Application of Goodman Water*.⁹
20 Staff's opposition to the settlement in that case was based, in part, on the allowance of a deferral of
21 accumulated depreciation and annual depreciation expense.¹⁰

22 The amount and magnitude of the debit balances in this matter warrant further investigation.
23 To date, the Company has not provided sufficient evidence to support these balances. Staff

24 _____
25 ³ Rimback Surrebuttal Test., Ex. S-15 at 8.

26 ⁴ See Ex. R-14.

27 ⁵ See Tr. at 109, 111-112, 1100.

28 ⁶ Tr. at 133.

⁷ *Id.*

⁸ Company Br. at 9.

⁹ Docket No. W-02500A-10-0382.

¹⁰ Decision No. 72897 at 15.

1 recommends removal of negative gross plant balances with the associated accumulated depreciation,
2 and also the removal of debit accumulated depreciation balances for rate making purposes and correct
3 transfers of assets that were treated as retirements so that the correct balance is reflected for rate
4 making purposes.¹¹

5 **B. The Inclusion Of Post-Test Year Plant Is Appropriate In This Case.**

6 RUCO is highly critical of Staff's recommendation to include post test year plant. RUCO
7 places much weight on Staff's recommendations as if Staff's recommendations carry the weight of a
8 Commission decision. Staff, like every other party to this case, reviews the evidence and makes its
9 recommendation. The Commission is free to accept or reject Staff's recommendation. It is the
10 Company, not Staff, who has the burden of proof in support of its application.

11 While the Commission adopted Staff's recommendations concerning criteria to use when
12 evaluating whether post test year plant should be added to rate base in prior Decisions, the
13 Commission has stated that it considers whether the inclusion of post test year plant is appropriate on
14 a case-by-case basis.¹² The Commission went on to say: "In the past, the Commission has allowed the
15 inclusion of post test year plant in circumstances where the new plant is revenue neutral and there is
16 no evidence of a material mismatch between revenue and expenses and where the post test year plant
17 is required for system reliability or to provide adequate service."¹³

18 RUCO claims that "Staff has changed its historical approach on post-test year plant."¹⁴ A
19 review of several rate cases where post test year plant has been at issue reveals that Staff reviews the
20 facts and circumstances of each application where the inclusion of post test year plant has requested
21 and makes its recommendations accordingly.

22 *In the Matter of the Application of Rio Rico Utilities, Inc.* the Commission rejected the
23 recommendation of Staff regarding post test year plant.¹⁵ Staff recommended against inclusion of post
24 test year plant. Staff asserted that post test year plant violates the matching principle, where rate base,
25 revenue and expenses are calculated at the same point in time. Staff further asserted that the impacts

26 ¹¹ Rimback Direct Test., Ex. S-14 at 23.

27 ¹² Decision No. 67279 at 6.

28 ¹³ *Id.*

¹⁴ RUCO Br. at 5.

¹⁵ Decision No. 67279 at 5.

1 of Rio Rico's post test year plant on revenues and expenses were not known and measurable. The
2 Commission found that the preponderance of evidence indicated that the post test year plant that the
3 Company sought to include in rate base was installed to serve existing test year customers, was
4 required for system reliability and that there would not be a material impact on revenue or expenses.
5 The Commission allowed the Company to include post test year plant.¹⁶

6 *In the Matter of the Application of UNS Gas, Inc.*, UNS Gas requested that the Commission
7 include construction work in progress ("CWIP") in rate base and in the alternative, if the Commission
8 were not inclined to grant that request, that the CWIP be included as post test year plant.¹⁷ Staff
9 recommended against the inclusion of post test year plant. The Commission adopted Staff's
10 recommendation finding that:

11 Although the Commission has allowed post-test-year plant in several prior cases
12 involving water companies, it appears that the issue was developed on the record in
13 those proceedings in a manner that afforded assurance that a mismatch of revenues did
14 not occur. For example, in Decision No. 66849 (March 19, 2004), we stated that "we
15 do not believe that adoption of this method would result in a mismatch because the
16 post-test-year plant additions are revenue neutral (i.e., not funded by CIAC or
17 AIAC)."¹⁸

18 What is post test year plant? Post test plant, plant that was in service after the test year, is basically a
19 pro forma adjustment to the test year rate base. Commission rules allow pro forma adjustments "to
20 obtain a normal or more realistic relationship between revenues, expenses and rate base."¹⁹ It is clear
21 that Commission rules contemplate that there are circumstances where pro forma adjustments to allow
22 for plant placed in service post-test year be included in rate base.

23 RUCO is inaccurate in its description of Staff's reasoning behind its recommendation. Staff
24 testified that Staff included it [Recurring Projects] as necessary for the efficiency of the water and
25 wastewater company.²⁰ Contrary to RUCO's assertion that "Staff is opening up post-test year plant to
26 just about anything without an explanation."²¹, Staff's reasoning is in line with prior Commission

26 ¹⁶ *Id* at 7.

27 ¹⁷ Decision No. 70011 at 5, 7.

28 ¹⁸ *Id.* at 8.

¹⁹ A.A.C. R14-2-103(A)(3)(i).

²⁰ Tr. at 829.

²¹ RUCO Br. at 7.

1 decisions and Staff's prior recommendations.²² Staff continues to recommend the inclusion of post
2 test year plant.

3 **II. OTHER ISSUES.**

4 **A. Staff Continues To Recommend A Purchase Power Adjustor Mechanism.**

5 Staff continues to recommend that the Company recover power expenses through a Purchase
6 Power Adjustor Mechanism ("PPAM"). Staff recommends approval of the Company's proposed
7 PPAM with the following conditions:

8 (i) EPCOR is allowed to pass through to its customers the increase or decrease in
9 purchased power costs that result from a rate change from any regulated electric service
10 provider supplying retail service to EPCOR;

11 (ii) Within 90 days of the Decision for this rate filing, EPCOR must file a Plan of
12 Administration ("POA") for the PPAM for Commission approval; and

13 (iii) EPCOR will only recover increases or refund decreases that are due to changes in
14 purchased power rates.²³

15 RUCO argues that "Staff and the Company do not want to pass on to customers any of the
16 lowered cost gained through energy efficiency programs."²⁴; RUCO does not grasp the purpose of a
17 PPAM. As Staff testified, the PPAM that Staff is recommending is designed to recover any changes
18 to the rates charged by an electric service provider. Conservation savings are not the focus of this
19 adjustor. This adjustor addresses the change in the base rate of power being charged to the utility by
20 its electric service provider.

21 **B. The Company's Request For An Affordable Health Care Adjustor Should Be**
22 **Rejected.**

23 The Company requested an Affordable Health Care Adjustor Mechanism ("ACAM") based on
24 the volatility of employees' health care costs. As Staff testified, the Company is unsure of how the
25 Affordable Health Care Act will impact health care costs for its employees. Since EPCOR already
26

27 ²² "the post-test year plant is prudent and necessary for the provision of services...." Decision No.
71410 at 10-11.

28 ²³ Payne Direct Test., Ex. S-12 at 59.

²⁴ RUCO Br. at 43.

1 offers health insurance for its full-time employees, it should already be in compliance with the federal
2 law stating that large businesses must offer health insurance to their employees.²⁵ Staff disagrees with
3 the Company's request for an ACAM-because it is not known or measurable.²⁶ Since the Act was
4 passed in 2010, no one knows how the ACAM will impact health care costs, particularly for large
5 corporations. No other utility company has requested an ACAM. In addition, Staff believes that the
6 AHCA may not affect significantly impact large corporations such as EPCOR.²⁷ Staff recommends
7 against approving the Company's request.

8 **C. There Is A Need For Additional Storage In Tubac.**

9 SCVCC questions the need for additional storage in Tubac, citing a Staff Report filed in
10 another docket.²⁸ However, Staff continues to recommend additional storage for Tubac.

11 In the prior rate case for Tubac, Staff recommended that the Company install an arsenic
12 treatment facility.²⁹ At that time, Staff determined that the Company had 3 wells in operation, well
13 numbers 2, 4 and 5. Well number 3 was inactive. Staff calculated the system capacity at 1180 gallons
14 per minute ("GPM"). Staff recommended no additional storage. The Commission did not order any
15 additional storage at that time.³⁰

16 In 2009, the Company requested approval to execute a loan agreement for \$2.3 million with
17 from the Water Infrastructure Finance Authority ("WIFA") for its arsenic treatment facility.³¹ The
18 proposed treatment facility was designed to treat 500 GPM, and the Company planned to alternate
19 treatment between the two wells, wells number 4 and 5, each of which has a flow rate of 500 GPM.
20 Well Number 2 was inactive. Well Number 4 and 5 would be the wells treated for arsenic. Well
21 Number 3 did not need treatment and was inactive at the time of the Staff Report. The arsenic
22 treatment facility is designed to treat only one well at a time. Staff expressed concern that the
23 operation of the system at a maximum of 500 GPM, with the proposed alternating well plan for
24

25 ²⁵ Payne Direct Test., Ex. S-12 at 56.

26 ²⁶ *Id.* at 57.

27 ²⁷ *Id.*

28 ²⁸ SCVCC Br. at 4-6.

29 ²⁹ Docket No. W-01303A-08-0227, Hains Engineering Report.

30 ³⁰ Decision No. 71410.

31 ³¹ Docket No. W-01303A-09-0152.

1 arsenic treatment, would leave the system short of storage capacity. Therefore, Staff recommended
2 that the Company be required to install a minimum of 500,000 gallons of additional storage capacity.³²

3 Staff later amended its recommendation on the additional storage because of additional
4 information received from the Company. At the time Staff prepared its Engineering Memorandum
5 and analysis it was Staff's understanding that the Company's Well Number 3 had not been and would
6 not be in service for an extended period. The Company later informed Staff that the third well was
7 returned to service. Staff then changed its recommendation and found that no additional storage
8 would be necessary.³³ The Commission adopted Staff's recommendations.³⁴

9 Pursuant to Decision Nos. 67093, 67593, 68310, 68825, and 71410, the Company filed an
10 application on March 5, 2010 requesting authorization to implement Step-One of the Arsenic Cost
11 Recovery Mechanism ("ACRM") for Tubac Water. Staff indicated at that time that additional storage
12 was needed, but did not specify an amount. Decision No. 71867 did not order the Company to provide
13 additional storage.

14 Staff's recommendation for additional storage remains appropriate. The Company's Tubac
15 system is made up of three zones. The water system has one storage tank with a total storage capacity
16 of approximately 50,000 gallons located in Zone 3. Zone 1 and 2 do not have storage tanks. Staff
17 concluded that based on peak month usage and the number of connections, the water system does not
18 have adequate storage capacity to serve the present customer base and any reasonable growth.³⁵

19 **III. SYSTEM IMPROVEMENT BENEFITS MECHANISM.**

20 RUCO continues to challenge the legality of the System Improvement Benefits Mechanism
21 ("SIB"). The SIB comports with the requirements of Arizona law.

22 ...

23 ...

24 ...

25
26 ³² May 13, 2009 Staff Report, Engineering Memorandum at 5.

27 ³³ June 1, 2009 Staff Report at 1-2.

28 ³⁴ Decision No. 71168. The Recommended Opinion and Order was amended by the Commission to
exclude Staff's earlier recommendation for additional storage. It appears however, that Finding of
Fact 26 inadvertently contains Staff's prior recommendation for storage.

³⁵ Thompson Engineering Direct Test., Ex. S-1, MST-4 at 2.

1 **A. The SIB Mechanism Is Consistent With The Requirments For An Interim Rate.**

2 RUCO argues that only where the Company has requested interim rates can the Commission
3 engage in rate making without finding fair value.³⁶ RUCO cites to the *Residential Utility Consumer*
4 *Office v. Arizona Corporation Commission* case in support of its argument.³⁷ RUCO asserts that the
5 Commission's authority to establish interim rates is limited to circumstances where the Commission
6 finds that an emergency exists, a bond is posted by the utility guaranteeing a refund if interim rates are
7 higher than final rates determined by the Commission, *and* the Commission undertakes to determine
8 final rates after making a finding of fair value.³⁸

9 Although Arizona case law is somewhat inconsistent as to what constitutes an interim rate,
10 what is consistent is the requirement that the rates are subject to reconciliation or 'true-up' in a
11 subsequent hearing and any charges are subject to refund.³⁹ The SIB surcharge mechanism meets
12 those criteria.

13 In *Pueblo Del Sol Water Company and Scates*, contrary to *Rio Verde*, the court indicated that
14 interim rates are not limited to emergency situations, and further opined that there are three
15 circumstances where the Commission can authorize interim rates with no "fair value" determination
16 and still comport with the Arizona Constitution. Interim rates are permissible when the rate is set
17 pending the establishment of a permanent rate, in emergency situations, or where a bond is posted that
18 guarantees a refund to consumers for any excess paid by them prior to the Commission's final
19 determination.⁴⁰ The SIB will meet the first criteria because the Company will be required to file a
20 rate application by a date certain.

21 Even viewing the SIB through the lens of the *Rio Verde* case you arrive at the same result.
22 First and foremost, the facts and circumstances of the surcharge at issue in the *Rio Verde* case are
23 distinguishable from those involving the SIB in this case. In *Rio Verde*, the company filed an

24 _____
25 ³⁶ RUCO Br. at 64, citing *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-35, 578 P.2d 612, 614-16
(App. 1978).

26 ³⁷ 199 Ariz. 588, 20 P.3d 1169 (App. 2001). This case shall be referred to as the *Rio Verde* case—
27 which was the name of the utility in that case—to avoid confusion with the use of RUCO.

28 ³⁸ RUCO Br. at 63-64.

³⁹ See, e.g., *Rio Verde, Pueblo Del Sol and Scates*.

⁴⁰ *Pueblo Del Sol Water Co. v. Ariz. Corp. Commission*, 160 Ariz. 285, 287, 772 P.2d 1138, 1140
(App.1988).

1 application for a surcharge to recover increases in the cost of water purchased from the Central
2 Arizona Project.⁴¹ The Commission staff reviewed and analyzed the data provided by the Company
3 and recommended that the Commission reject the company's application and conduct a full rate
4 hearing. The Commission ultimately approved the company's application. Although in its findings of
5 fact the Commission did determine the company was earning less than its authorized rate of return, the
6 Commission also found that the company's operations had changed significantly since its last rate case
7 and therefore ordered that the company file a rate application within six months. The surcharge would
8 be subject to true up at that time. Importantly, the Commission made no "fair value" finding at the
9 time that it authorized the surcharge for the company. In other words, this analysis may only be
10 appropriate in those circumstances where the Commission makes no "fair value" finding.

11 In contrasting the surcharge at issue in *Rio Verde* with the SIB, the differences are significant.
12 Here the SIB provides for a detailed engineering analysis of the proposed plant needing replacement,
13 including a timeline for replacement and estimated costs. The replacement plant is approved for
14 processing through the SIB mechanism in the rate case. Commission Staff reviews the cost estimates
15 for reasonableness in the rate case. The Company provides six month updates on the progress of the
16 construction of the approved projects and the actual costs to date. When the Company files its
17 applications to implement a SIB Surcharge, it provides significant information regarding the projects,
18 including all back up information regarding the actual cost of the plant. This allows Staff and other
19 parties the opportunity to review the cost information to ensure that the Company surcharge is correct.
20 Further, the Company provides financial information that allows the Commission to determine the fair
21 value rate base of the Company with the inclusion of the additional SIB plant, and the impact the
22 surcharge will have on the fair value rate of return. The Company provides notice to its customers
23 prior to filing the surcharge application, and again prior to being allowed to implement any surcharge
24 that may be authorized by the Commission. Finally, the surcharge is subject to true-up, and the
25 Company is required to file a rate application by a date certain. In fact, the only similarity between
26 the SIB mechanism and the surcharge in *Rio Verde* is the requirement for the Company to file a follow
27 up rate application.

28 _____
⁴¹ *Rio Verde*, 199 Ariz. at 589, 20 P.3d at 1170.

1 The *Rio Verde* court indicated that the purpose of requiring all three elements was to comport
2 with the constitutional mandate that rates be just and reasonable.⁴² It is because of this “fair value”
3 determination that the other interim rate safeguards of there being an emergency and that the company
4 post a bond to guaranty refunds cease to be necessary.⁴³ Since the Commission is complying with its
5 constitutional mandate through the use of fair value, the interim SIB surcharges result in just and
6 reasonable rates. In other words, the SIB is an interim rate. It is simply an interim rate in which the
7 Commission determines and uses fair value each time it sets a SIB surcharge for the recovery of SIB
8 plant capital costs. In this way, the SIB also is consistent with Arizona law.

9 **B. The SIB Is A Valid Step Increase Mechanism That Is Completely Consistent With**
10 **The “Fair Value” Provision Of The Arizona Constitution.**

11 RUCO makes two arguments regarding the SIB and fair value. First, RUCO argues “the
12 Commission will not, as required by law, make a meaningful finding of fair value and use that finding
13 as a rate base for the purposes of establishing rates” because in part, the Commission will not be
14 considering operating expenses associated with the SIB plant. Second, RUCO argues that because the
15 Commission will not be finding a “new” fair value rate base upon its consideration of a company’s
16 request for a SIB surcharge, but merely “updating” the prior fair value finding, that the Commission
17 will not be able to make a “meaningful” FVRB finding, and thus run afoul of its constitutional
18 obligation to find fair value.⁴⁴ RUCO makes this argument in the face of extensive financial
19 submissions required to be made by the Company, designed to enable the Commission to determine
20 the impact of the newly installed plant on the Company’s fair value rate base and to consider the
21 resulting impact on the Company’s fair value rate of return.

22 Article XV, Section 14 (the “fair value” provision of the Constitution) states:

23 The Corporation Commission shall, to aid it in the proper discharge of its duties,
24 ascertain the fair value of the property within the State of every public service
25 corporation doing business therein....
26

27 ⁴² *Id.* at 592, 20 P.3d at 1173.

28 ⁴³ *Id.*; *Pueblo Del Sol*, 160 Ariz. at 287, 772 P.2d at 1140.

⁴⁴ RUCO Br. at 62.

1 The only authority that RUCO cites to support its arguments is *Scates*. RUCO claims that the
2 ruling in *Scates* prohibits the Commission from making a fair value determination unless it is
3 “meaningful.”⁴⁵ Nothing in *Scates* distinguishes between what is and is not meaningful. The court in
4 *Scates*, criticized the Commission for increasing rates *without a determination of fair value rate base*:

5 We . . . hold that the Commission was without authority to increase the rate without
6 any consideration of the overall impact of that rate increase upon the return of . . . [the
7 utility], and without, as specifically required by our law, a determination of . . . [the
utility’s] rate base.⁴⁶

8 In *Scates*, the Commission approved a rate increase of almost five million dollars without
9 determining the Company’s fair value rate base and without considering the effect of the increase
10 upon the company’s fair value rate of return.⁴⁷ By contrast, the SIB mechanism specifically requires
11 the Company to provide updated financial information, such as Earnings, Rate Base and Revenue
12 Requirement Schedules.⁴⁸ This information will allow the Commission to appropriately consider and
13 evaluate the Company’s fair value rate base and fair value rate of return.

14 The proposed SIB fully complies with Arizona’s fair value standard. As the Arizona Supreme
15 Court explained in *Simms v. Round Valley Light & Power Company*, “While our constitution does not
16 establish a formula for arriving at fair value, it does require such value to be found and used as the
17 base in fixing rates. The reasonable and justness of the rates must be related to this finding of fair
18 value.”⁴⁹ “Fair value means the value of properties at the time of inquiry.”⁵⁰ Here, the SIB requires a
19 determination of the fair value of the Company’s rate base along with the SIB plant at the time that the
20 surcharges are proposed.

21 All the Constitution requires is that the Commission determine and consider fair value in
22 setting rates, as reinforced in the Arizona Supreme Court’s decision in *US West Communications, Inc.*
23 *v. Arizona Corporation Commission*. The Court’s decision illustrates that point:

24 ⁴⁵ *Id.*

25 ⁴⁶ 118 Ariz. at 537, 578 P.2d at 618.

26 ⁴⁷ *Id.* at 534, 578 P.2d at 615.

27 ⁴⁸ See Thompson Direct Test., SIB Plan of Administration, Ex. S-1.

28 ⁴⁹ 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

⁵⁰ *Id.*; See also *Consolidated Water Utilities, Ltd., v. Ariz. Corp. Comm’n*, 178 Ariz. 478, 482 n. 6,
875 P.2d 137, 141 n. 6 (App. 1993) (“The fair value rate base is the fair value of the company’s
properties within the state at the time the rate is fixed.”)

1 [W]e hold that a determination of fair value is necessary with respect to a public service
2 corporation. But what is to be done with such a finding? In the past, fair value has been
3 the factor by which a reasonable rate of return was multiplied to yield, with the addition
4 of operating expenses, the total revenue that the corporation could earn. That revenue
5 figure was then used to set rates.... But while the Constitution clearly requires the
6 Arizona Corporation Commission to perform a fair value determination, only our
7 jurisprudence dictates that this finding be plugged into a rigid formula as part of the
rate-setting process. Neither section 3 nor section 14 of the constitution requires the
corporation commission to use fair value as the *exclusive* rate basis.... In this and any
other fashion that the corporation commission deems appropriate, the fair value
determination should be considered. The commission has broad discretion, however, to
determine the weight to be given this factor in any particular case.⁵¹

8 The Court of Appeals' decision in *Phelps Dodge Corporation v. Arizona Electric Power*
9 *Cooperative, Inc.* echoes those sentiments: " it is consistent with the pronouncement in *US West II...*
10 that the Commission should consider fair value when setting rates within a competitive market,
11 although the Commission has broad discretion in determining the weight to be given that factor in any
12 particular case."⁵² RUCO cannot convincingly argue that the Commission will not find fair value,
13 whether new or updated, and then use that information to develop the SIB surcharge.

14 The SIB mechanism is designed to address the Company's infrastructure replacement program.
15 In a meaningful way, the SIB seeks to balance the interests of the Company with the interests of its
16 ratepayers, thereby providing appropriate cost recovery for the Company and cost-effective utility
17 service for customers.

18 **C. The SIB Is A Valid Adjustor Mechanism And May Also Be Considered A Valid**
19 **Step Increase Mechanism.**

20 RUCO argues that the SIB is not an adjustor mechanism, citing again to *Scates* and *Rio*
21 *Verde*.⁵³ RUCO's argument in a nutshell is that adjustor mechanisms are only permissible for the
22 recovery of "narrowly defined operating expenses," and that because the SIB recovers the capital costs
23 of plant investment rather than operating expenses, it is not permissible under Arizona law.⁵⁴

24 The Arizona Court of Appeals has expressed several exceptions to the requirement that the
25 Commission can only set rates based on the fair value of the rate base and determining the impact of
26

27 ⁵¹ 201 Ariz. 242, 245-46, 34 P.3d 351, 354-55 (2001) (internal citations omitted).

28 ⁵² 207 Ariz. 95, 106, 83 P.3d 573, 584 (App. 2004).

⁵³ RUCO Br. at 58-60.

⁵⁴ *Id.*

1 the rates on the fair value rate of return.⁵⁵ The Arizona Court of Appeals has indicated that an
2 exception to the requirement that the Commission determine and use fair value in setting rates is met
3 when the Commission does so through an adjustment clause that is established in a rate case.⁵⁶

4 Importantly, neither *Scates* nor *Rio Verde* involved plant-based adjustors. As noted above, in
5 *Scates*, the court's ruling was that the Commission did not comply with the fair value requirement in
6 the Arizona Constitution.⁵⁷ In *Rio Verde*, the court determined that the Commission had disregarded
7 the requirements for an interim rate, and that the surcharge at issue did not qualify as an automatic
8 adjustor.⁵⁸ The court determined that the surcharge did not qualify as an adjustor because it was not
9 created within the context of a rate case.⁵⁹ There is nothing about the SIB mechanism that is
10 inconsistent with these holdings.

11 Even if not an adjustor, it is a lawful step mechanism. In *Arizona Community Action*
12 *Association v. Arizona Corporation Commission*, the court upheld step rate increases based on plant
13 additions completed after the close of the rate case.⁶⁰ In that case, the company was granted an initial
14 six percent rate increase. In the following two years, the company was permitted to increase its rates
15 by a maximum of five percent per year, if certain conditions were met. For the step 2 increase, the
16 company was permitted to increase its rates by the lesser of either five percent of gross operating
17 revenues or a revenue deficiency, which was

18 calculated by first totaling (1) *the amount of electric properties placed in service since*
19 *the prior rate increase*, (2) *construction work in progress for the preceding calendar*
20 *year for any plant for which construction work in progress had previously been*
21 *included in rate base*, and (3) *construction work in progress during the preceding*
22 *calendar year for plants scheduled to go into service within two years.*⁶¹

23 ⁵⁵ *Scates*, 118 Ariz. at 535, 578 P.2d at 616.

24 ⁵⁶ *Id.*; *Rio Verde*, 199 Ariz. at 591-92, 20 P.3d at 1172-173.

25 ⁵⁷ 118 Ariz. at 537, 578 P.2d at 618.

26 ⁵⁸ 199 Ariz. at 592-93, 20 P.3d at 1173-74.

27 ⁵⁹ *Id.*

28 ⁶⁰ 123 Ariz. 228, 599 P.2d 184 (1979). Although the Court overturned the Commission's decision
relating to the step-increases in *Arizona Community Action*, the Court explained that it was because
the Commission had placed the trigger for the step increases solely in the hands of the utility. *Id.* at
231, 599 P.2d at 187. The SIB mechanism at issue in this case has no automatic trigger and,
consequently, each step increase must be explicitly approved by the Commission at the time that the
Company seeks to implement it.

⁶¹ *Id.* at 229, 599 P.2d at 185 (emphasis added).

1 The sum of these amounts was then to be multiplied by the rate of return on electric plant previously
2 authorized by the Commission.

3 The Court upheld this portion of the Commission's order:

4 The Commission stated in the decision under attack that it . . . would initiate *innovative*
5 *procedures in an attempt to deal promptly and equitably with increasingly complex*
6 *regulatory matters*. At the Step I hearing, the Commission fulfilled the constitutional
requirements of art. 15, §§ 3, 14, which mandate a finding of the fair value of all
property at the time of fixing a rate.⁶²

7 The court further indicated that it did not "find fault" with the Commission's efforts to avoid a
8 "constant series of extended rate hearings" ⁶³ Finally, the court noted that the Commission's
9 order in the rate case "resulted in a determination of fair value" and that further adjustments *between*
10 *rate cases* "were adequate to maintain a reasonable compliance with the constitutional requirements if
11 *used only for a limited period of time.*" ⁶⁴ The Court's specific language is instructive:

12 [W]e find entirely reasonable that portion of the Commission's decision allowing the
13 inclusion of construction work in progress to go on line within two years of the
effective date of the Step II increase. Nor do we find fault with the Commission's
14 attempt to comply with our indication in *Arizona Corporation Commission v. Arizona*
15 *Public Service, supra*, that a constant series of extended rate hearings are not necessary
to protect the public interest. The hearing culminating in the order of August 1, 1977,
16 resulted in a determination of fair value. The adjustments ordered by the Commission
in adding the CWIP to that determination of fair value were adequate to maintain a
17 reasonable compliance with the constitutional requirements if used only for a limited
period of time.⁶⁵

18 In the present case, the distribution plant eligible for consideration under the SIB mechanism is
19 very similar to the post-test-year plant addressed in *Arizona Community Action*.⁶⁶ However, in that
20 case, the step increases went into effect without specific updates to the Company's fair value rate base.
21 Here, the Commission's SIB mechanism requires specific "financial and statistical" information to
22 accompany each SIB surcharge request.⁶⁷ That information will be used to determine an updated fair
23

24 _____
25 ⁶² *Id.* at 230, 599 P.2d at 186 (emphasis added).

26 ⁶³ *Id.*

27 ⁶⁴ *Id.* at 231, 599 P.2d at 187 (emphasis added).

28 ⁶⁵ *Id.* at 230-31, 599 P.2d 186-88.

⁶⁶ *See also Arizona Corp. Comm'n v. Ariz. Pub. Serv. Co.*, 113 Ariz. 368, 371, 555 P.2d 326, 329
(1976) (noting that Commission may consider addition of post-test-year plant when determining rate
base).

⁶⁷ *See Thompson Direct Test., Plan of Administration, Ex. S-1.*

1 value rate base. The SIB mechanism, therefore, includes even more fair value safeguards than were
2 contained in the step increase mechanism approved by the Court in *Arizona Community Action*.

3 The Company presented sufficient testimony to support its SIB request.⁶⁸ Staff found the
4 Company's request to be reasonable and recommends its approval.

5 **IV. CONCLUSION.**

6 Throughout this case, Staff has presented evidence to support its requested recommendations.
7 Staff's recommendations, if adopted, will provide the Company with sufficient revenue while balancing
8 the interests of the Company's customers. Staff's testimony, Initial Post-Hearing Brief and this Reply
9 Brief adequately summarize the evidence that its recommendations are reasonable and would urge the
10 adoption by the Commission.

11 RESPECTFULLY SUBMITTED this 30th day of April, 2015.

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25 April, 2015, with:

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⁶⁸ Coleman Direct Test., Ex. A-24 at 5-12.

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